Experian Business Debt Index (BDI)

Q1 2017

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ECONOMETRIX (PTY) LTD

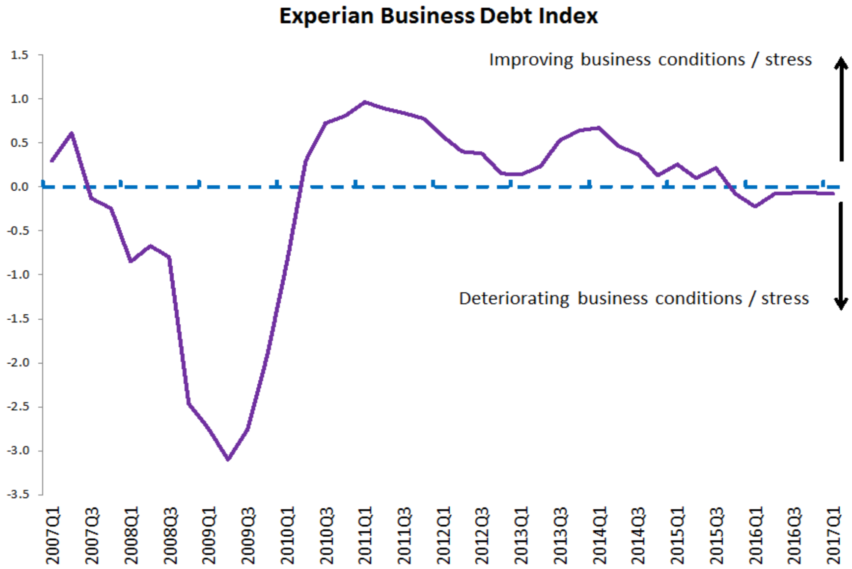
EXPERIAN BUSINESS DEBT INDEX (BDI) RESULTS FOR Q1 2017

BDI outcome shows no dramatic deterioration in business debt conditions

The Experian Business Debt Index (BDI) declined in the 1st quarter of 2017, to a reading of -0.081, from a revised -0.069 in the fourth quarter of 2016. (A reading below zero indicates a deterioration in the financial position of businesses, whereas a positive reading implies an improvement.)

The BDI has fluctuated in a range between a low point of -3.10 at the height of the global financial recession in 2009 and a high point of 0.962 in the first quarter of 2011 during the recovery from recession. As such, the first quarter movement in the BDI has to be seen as marginal. It does not constitute any dramatic deterioration in business debt conditions.

Chart 1



	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Index >0= Improving business conditions <0 = Deteriorating business conditions	-0.228*	-0.081*	-0.070*	-0.069*	-0.081

* *Revised*

On the one hand, low levels of business confidence created by political uncertainty resulted in business conditions taking much strain in 2016, which is likely to have resulted in some deterioration in business balance sheets. On the other hand, precisely because business confidence in the economic outlook has been low, companies have deliberately been somewhat conservative in their financial strategies, preferring to shore up their balance sheets rather than embark upon new ventures that might require using up cash reserves or taking on more debt and through this impairing the potential solvency of the organisation. Whilst the slowdown in macroeconomic growth in 2016, from 1.3% in 2015, to just 0.3% in 2016 must have squeezed the ability of companies to generate cash, the 3.9% decline in capital investment alleviated the need to deploy cash to the same extent as in the preceding year.

This picture has been a recurring theme over the past year, contributing towards a fairly flat outcome for the BDI over successive quarters, at levels which have been marginally negative, indicative of a very modest net deterioration in financial conditions. With economic growth in 2016 having being barely positive, the apparent strategy of consolidation on the part of the business sector appears to have been vindicated. It seems to have contributed towards preventing a more serious deterioration in the economic environment which could have ensued in the absence of a conservative financial strategy.

Macroeconomic factors influencing Q1 2017

When we published the BDI for the fourth quarter of 2016 originally three months ago, we reported the index as being -0.0341, based on preliminary estimates of Q4 2017 domestic GDP, of 0.8% y/y.

Furthermore, we anticipated that in line with an improvement in domestic economic conditions in 2017, the BDI would turn positive in the first quarter of 2017, to a reading of 0.1637. In the event, y/y economic growth for Q4 2016 came in as a weaker 0.4% than the 0.8% figure we had forecast.

This was largely attributable to much lower-than-anticipated mining output figures for the end of last year. Incorporation of a weaker Q4 GDP figure has therefore contributed towards the reduction in the BDI for Q4 2016 to -0.0694 currently, from the initial estimate of -0.0341.

Furthermore, for the first quarter of 2017, recently released US economic growth reflect growth of 1.9% y/y compared with the 2.1% growth rate that had been forecast when the BDI was previously calculated.

In the wake of the election of Donald Trump as US President in November last year, optimism had prevailed that his commitment to large-scale infrastructural investment and substantial tax cuts would boost confidence in the US economy at the beginning of 2017 and thus cause economic growth to pick up.

However, growth has turned out to be softer than anticipated even if this has come to be seen by many analysts as a temporary setback caused by statistical factors. Nonetheless, it has contributed towards the BDI for the first quarter of 2017 coming in as slightly negative, at -0.0807, compared with the forecast a quarter ago for a positive BDI of 0.1637.

The changes are not dramatic but reflect a situation in which earlier expectations for a pickup in both global and domestic economic growth in 2017, have turned out to be overly optimistic. Internationally, disillusionment with success in the likely implementation of stimulatory measures by the new Trump administration has crept into the picture, whilst domestically also, heightened political turmoil has dampened earlier optimism about a renewal in business and consumer confidence.

Despite the deterioration in business confidence over the past two months, a huge deterioration in business debt conditions is not foreseen. Part of this lies in the fact that there are still some positive elements underlying the domestic economy.

Chart 2

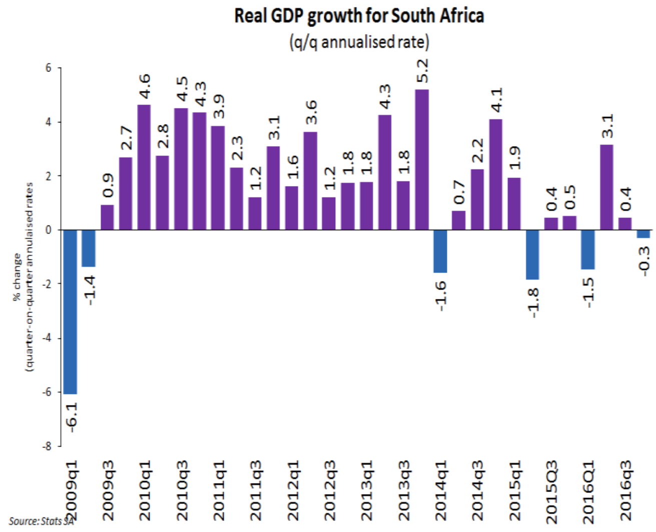


Chart 3

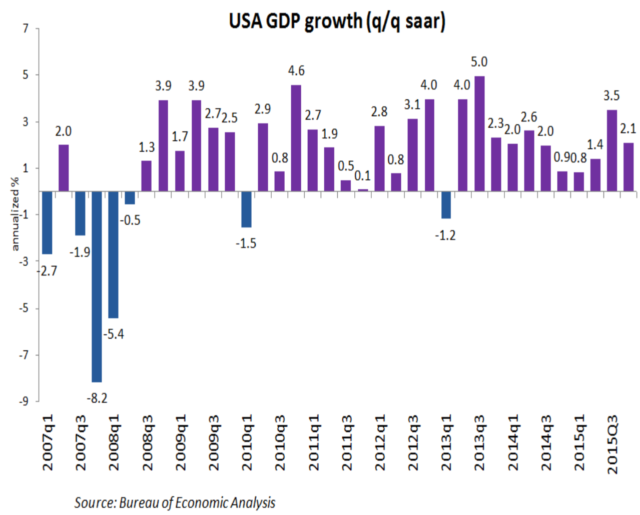
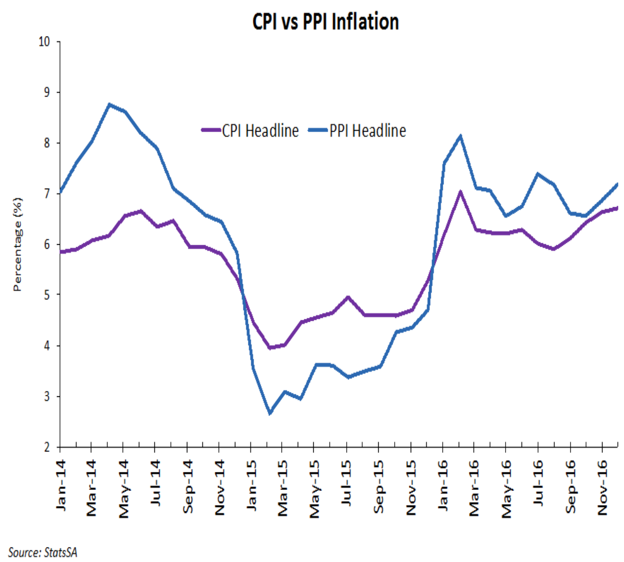


Chart 4

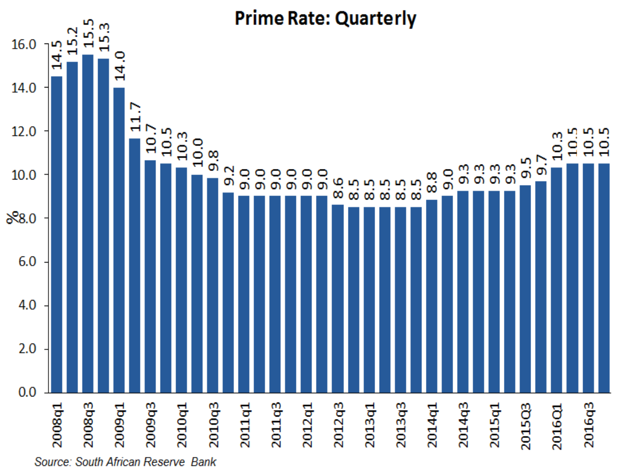


The most important amongst these is the ending of drought conditions and the consequential improvement in agricultural output which resulted in knock-on effects for the rest of the economy. Recent evidence also points to a substantial recovery in mining output.

Thirdly, inflation is set to moderate on the back of an unexpectedly firm exchange rate. In turn, this has defused fears that might have existed last year of a rise in domestic interest rates.

From an international perspective, the greater optimism has been reflected in an upward revision of global economic growth forecasts by the IMF for the first time in more than five years, driven by improvements in all the main advanced economies, as well as a recovery in some of the larger emerging markets such as Brazil and Russia on the back of the rally in commodity prices of the past year. As a result, the prospects for South African exports have improved.

Chart 5



BDI by sector

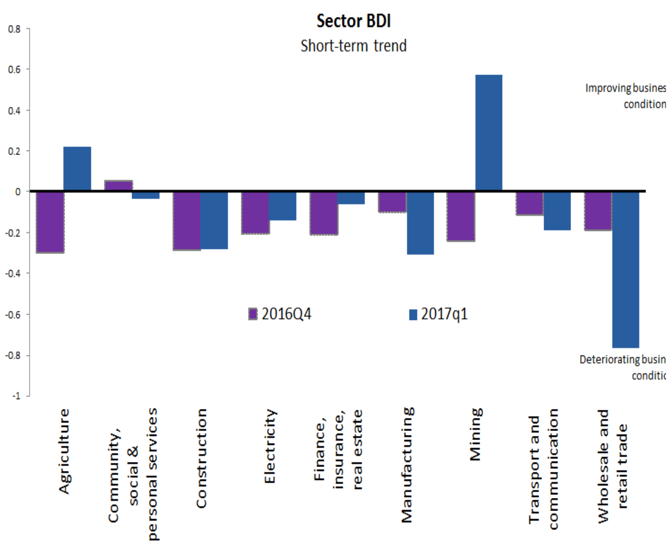
What was especially interesting to note was that, in contrast with previous quarters, the latest quarter was characterised a huge variance in the change in the BDI by sector.

Analysis of the sectoral breakdown of business debt conditions reveals a significant deterioration in conditions in the retail sector, but conversely an improvement in conditions in agriculture and mining. The latter two sectors took a huge knock in 2016 on the back of drought conditions and the falloff in the demand for commodities in the past couple of years. Not surprisingly, in light of the ending of drought conditions and the improvement in global commodity prices and mining output since the beginning of the year, the BDI for agriculture and mining turned significantly positive in Q1 of 2017.

It appears that the economic slowdown has only come to affect the retail sector more recently. Intensification of declines in business confidence seemed to have instilled increased caution amongst consumers to continue spending as before. This is likely to be exacerbated in coming months in the wake of substantial increases in personal taxation as well as the credit rating downgrades to junk status of commercial banks in line with the downgrades announced by S&P Global Ratings and Fitch on the government's foreign debt.

The downgrades are likely to make the banking sector more reticent to provide credit and to do so at a higher cost than before. Furthermore, there remains significant apprehension that there could be further downgrades to the country's credit rating. In the event that the ratings by S&P and Moody's on

Chart 6



local currency debt were to be reduced to sub-investment grade status, South African government bonds would stand to drop out of key world government bond indices, leading to large-scale capital outflows that would cause the rand to depreciate.

Concerns that such a scenario might yet materialise, with adverse effects on inflation, interest rates and economic growth more generally, are likely to perpetuate the caution of consumers to spend on borrowed money and the reluctance of businesses to invest in new projects.

Business debt metrics in Q1 2017

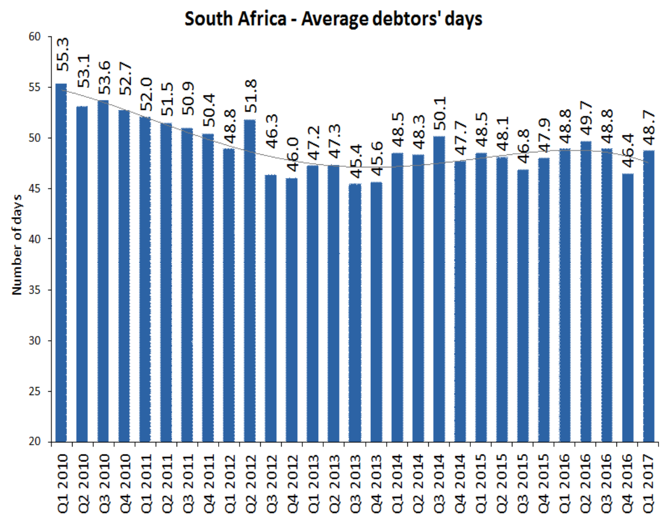
In line with the fairly sudden deterioration in the domestic economic outlook and the need to revise domestic economic growth forecasts downwards, the projected path of the BDI for coming quarters has turned negative, whereas previously it had been positive.

Debtors' days

In terms of the micro-indicators measured by Experian, there was a slight pickup in the average number of outstanding debtors' days in Q1 2017 compared with Q4 2016, from 46.4 days, to 48.7 days.

However, it is far too soon to call this a deteriorating trend. On the contrary, on reflection, after declining materially between 2010 and 2013, the average outstanding debtors' days has remained in an overall sideways trend in the range between 45 and 50 days.

Chart 6

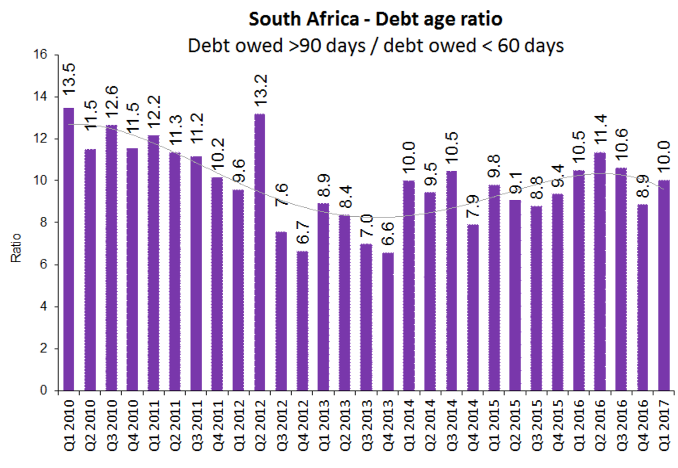


Debtors' days' ratio

In line with the increase in the overall number of outstanding debtors' days in the first quarter, the ratio of debtors' days outstanding in more than 90 days relative to those outstanding of less than 60 days, rose to 10.0 in the first quarter of 2017, from 8.9 in the Q4 2016. There was an even sharper increase in the ratio of debts outstanding for 30 to 60 days relative to debts owed of less than 30 days, from 15.5% in the final quarter of 2016, to 21.4% in the first quarter of 2017.

Again it is important to emphasise that there has been significant volatility in these figures from one quarter to the next and it is therefore inadvisable to call a trend based on the increase in outstanding debtors' days alone.

Chart 7



Source: Experian

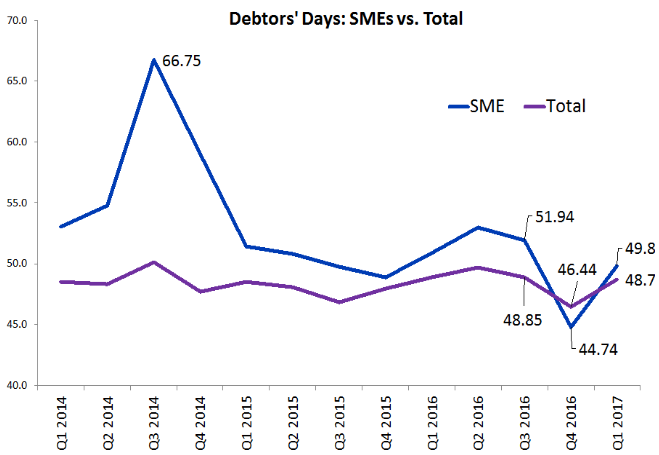
BDI by company size

Linked to the downturn in business conditions in the trade and accommodation sector, it is not surprising to see a marked increase in the number of small companies experiencing more difficult business debt conditions than was the case in the larger companies.

Gradually the erosion of cash flow generation might come to more than neutralise the conservation of cash due to the dearth of investment in terms of the impact on business debt conditions. This is likely to be especially the case in respect of small businesses where there already was a marked increase in the number of outstanding debtors' days in the Q1 2017, to 49.80 days, from 44.74 in Q4 2016.

The ratio of SMEs to the total sample of companies experiencing debt strain increased for a third successive quarter, to 22.7% in Q1 of 2017, as compared with just 17.3% in Q2 of 2016. Furthermore, the average number of outstanding debtors' days in respect of SMEs increased quite sharply in Q1 of 2017, to 49.80 days, from 44.74 days in the final quarter of last year.

Chart 11



Summary and Outlook

It is likely that a further deterioration in business and consumer confidence resulting from the Cabinet reshuffle will result in a further downturn in the desire of businesses to invest in capital projects. Moreover, the recent weakening of the rand could gather further momentum as a result of ongoing concerns that there could be further downgrades in the country's credit rating.

The concomitant risk of this is that there is now a real possibility that all three main credit rating agencies will come to downgrade the rating on local currency government debt to junk status. In the event of such a scenario materialising, there could be large-scale capital outflows from the domestic bond market, which will depress the rand more dramatically, with inflationary consequences.

In conclusion, based purely on the marginal deterioration in the BDI for Q1 of 2017, there appears to be no major cause for panic about the financial conditions of the business sector. However, such conditions are expected to worsen markedly from now on and our latest BDI suggests a deterioration in business debt conditions in Q2 and Q3 2017.

Explanatory notes regarding the Experian Business Debt Index

What is the Experian Business Debt Index?

The Experian Business Debt Index (BDI) is an indicator of the overall health of businesses, as well as the South African economy. It measures the relative ability for business to pay its outstanding suppliers/creditors (i.e. amounts owed to other businesses) on time and tracks macro-economic indicators that can impact on the ability of companies to pay its creditors.

A number of debtors and macro-economic variables are combined into a single indicator of business debt stress.
In other words, the BDI is a reflection of the overall health of businesses and the position of debt settlement between businesses in the economy.

How to interpret the index

The index is constructed around a mean value of zero.
Values above zero indicate less business debt stress and values below zero indicate business debt stress.
Given the underlying data of the index, relative higher levels of debt indicate a weakening in the ability to pay outstanding creditors. Higher interest rates result in higher borrowing costs and an increase in business stress. Relatively higher production costs vs consumer cost decreases operating margins of business, while higher domestic and international growth could result in a better trading environment for businesses.

Measured by using principle components

The Experian Business Debt Index (BDI) is constructed using principal components analysis. This is similar to the St. Louis Fed's Financial Stress Index (STLFSI) and the Kansas City Fed's FSI (KCFSI) in the USA. The principal components analysis is a statistical method that is used to extract factors responsible for the co-movement of a group of variables. As such, it is assumed that business stress is the primary factor influencing the co-movement and by extracting the principal components, it is possible to build an index with a useful economic interpretation.

Variables included

The Experian Business Debt Index is made up of Experian business debtors' data and public domain data. Variables include the following:

- 30 – 60 debtor days ratio (debt compared to initial amount invoiced 30 days ago);
- 60 – 90 debtor days ratio (debt compared to initial amount invoiced 60 days ago);
- South Africa consumer inflation and producer inflation spread;
- Interest rate spread (Repo vs US Federal Fund rates);
- Interest rate spread (R157 vs Repo);
- Real SA GDP (year-on-year percentage change);
- Real US GDP (year-on-year percentage change).

No provision is made for any leads or lags in any of the variables.

Methodology used to construct the index

The way the index is constructed is first to demean the individual indices by subtracting the index value from the index average and dividing it by the sample standard deviation (SD). The indices can now be expressed in the same units. Secondly, the method of principal components is used to calculate the coefficients of the variables in the EBSI. These coefficients are scaled so that the standard deviation of the index is 1. Lastly, each of the indices is multiplied by its respective adjusted coefficient.

When the index is updated quarterly, the values of the Experian Business Debt Index can change. This can occur either through a change in the coefficients (an updated re-estimation) or as a result of the change in the actual values of the variables in the original sample. This happens because the data are demeaned and standardised and as a result the value of the original sample will change as the sample mean and sample standard deviation of the variables changes.

About Experian

We are the leading global information services company, providing data and analytical tools to our clients around the world. We help businesses to manage credit risk, prevent fraud, target marketing offers and automate decision making. We also help people to check their credit report and credit score and protect against identity theft. In 2016, for the third year running, we were named one of the “World’s Most Innovative Companies” by Forbes magazine.

We employ approximately 17,000 people in 37 countries and our corporate headquarters are in Dublin, Ireland, with operational headquarters in Nottingham, UK; California, US; and São Paulo, Brazil.

Experian plc is listed on the London Stock Exchange (EXPN) and is a constituent of the FTSE 100 index. Total revenue for the year ended March 31, 2016, was US$4.6 billion.

To find out more about our company, please visit http://www.experianplc.com or watch our documentary, ‘Inside Experian’.

About Econometrix

Econometrix is South Africa’s largest independent macro-economic consultancy based in Johannesburg. We are privately owned and therefore totally independent of any official organisation or pressure groups. Econometrix – which has a successful track record of close to 30 years - is committed to on-going research and analysis of economic fundamentals thereby ensuring a sound basis for future business decisions. These services are provided through a range of complimentary products to more than 150 South African and international organisations.

Our approach is to empower our clients with quality decision support intelligence and assistance regarding the economic and financial environment, and assist them in their strategic and financial planning processes. Our in-depth analysis of economic fundamentals aims to assist our clients in commanding the economic environment and in identifying opportunities and risks.

Contact details

Analysis – Econometrix	+27 11 483 1421	jefferyd@econometrix.co.za
Enquires – Experian South Africa	+27 11 799 3400	taryn.stanojevic@experian.com

Next release date for the BDI: 15 August 2017

For more detailed analysis on the debt stress by sector, Experian publishes the *Business Debt Overview* report. Please contact Taryn Stanojevic at Experian for more information.